RELATIVE MERIT OF PARTNERSHIP AND CORPORATE ORGANIZATION UNDER THE INCOME TAX LAW

BY

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I HEREBY RECOMMEND THAT THE THESIS PREPARED UNDER MY SUPERVISION BY Henry Heaton Baily

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A study of the comparative burden imposed by the Federal Income and Excess-Profits Tax Law on the shareholder of a corporation and the member of a partnership for the year 1920.

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A. Introduction.

The Revenue Act of 1918 furnishes one of the chief sources of income for the United States Government. It provides for the taxation of the incomes of individuals by a normal tax and a graduated surtax. It also provides for the taxation of the profits of corporations by a normal tax and an excess-profits tax; the excess-profits tax being based on the relationship between the invested capital and the profit. Thus, the tax levy on a corporation is made in an entirely different manner from that on an individual.

The law does not recognize the partnership for the purpose of taxation. Any profit of the partnership is considered as a profit belonging to the individual owners and as such must be reported by the individuals for taxation, regardless as to whether it is distributed or not. This makes the profit of the partnership subject to the tax as it is levied on the income of the individual.

Since we have one method of levying the income tax on corporations and another method of levying the income tax on partnerships do they result in levying the same rate of tax in every case? An individual owns a half interest in a partnership which makes a profit of $10,000 per year. Will the tax on his share of the profits from the partnership be the same as it would be if the business were operated as a corporation? Under the present law does the form of the business organization affect the amount of the income tax? Other conditions being equal is the burden imposed on the stockholder of a corporation the same as that imposed on the member of a partnership? If the form of the business organization affects the amount of the income tax we may expect business men to take cognizance of this in forming their organizations in the future. If in a particular case one form of organization has a marked advantage over the other it may be worth while for the business man to reorganize his

business so as to take advantage of the form of organization which pays but a small income tax.

B. The burden placed by the income tax on the member of a partnership.

Since the Income Tax Law does not recognize a partnership as a distinct organization, the income of a partnership as such is not taxable. A return must be made setting forth the income of the partnership and the shares for the division of profits. However, the purpose of the return is to enable the tax commissioners to check the income of the partnership with the income as reported by the individual. It is in the nature of a supplementary return. Each partner in his own return must show his share of the net taxable income regardless of whether the income or any part of it has been distributed. Each partner is taxed on his share of the profits just as though the profit was made by him alone and not in an association of individuals.

The individual pays two taxes, a normal tax and a surtax. For the purpose of the normal tax certain credits are allowed and then the first $4,000 of income is taxed at the rate of four percent and the rest of the income at the rate of eight percent. The surtax is imposed on incomes of over $5,000. On an income of from $5,000 to $6,000 the rate of the surtax is one percent. From $6,000 to $100,000 the rate of the surtax increases one percent with every increase of $2,000 in the income of the individual. This makes a surtax rate of forty-eight percent on that portion of an income which is over $98,000 and does not exceed $100,000. On that part of the income which is over $100,000 but does not exceed $150,000 the rate of the surtax is fifty-two percent, while between $150,000 and $200,000 the rate is fifty-six percent. [1]

A large number of cases have been studied in order to get a definite idea of the burden laid by the tax on the individual who owns an interest in

1--Revenue Act of 1918, Sections 210, 211.

a partnership. Calculations have been made to show the percent of the net profits the individual would pay as income tax provided:-

(a) He owns either 10%, 25%, 33 1/3%, 50%, 66 2/3%, 75%, 90%, or 98% interest in the profits.

(b) The individual has an income from other sources amounting to -0-; $2,000; $5,000; $10,000; $15,000; $25,000; $35,000; $50,000; $75,000 or $100,000.

(c) The taxable income of the partnership was $5,000; $10,000; $15,000; $20,000; $25,000; $35,000; $50,000; $75,000 or $100,000.

(d) The personal exemption of the individual is $2,000.

The calculations were made for each combination of share owned, the income of the individual from other sources, and income of the partnership.

The method of determining the tax paid by an individual on the share of the income derived from the partnership, was to find the tax the individual would pay if there were no earnings from the partnership, and then to find the tax he would pay if the partnership makes a given profit. The difference between the amounts of the taxes thus found can properly be considered as the tax paid on the profits of the partnership. This difference, divided by the individual's share of the profits, gives the percent of the profits that he must pay to the government as a tax.

In the case of a single proprietorship or partnership the full effect of the tax does not manifest itself until the net income of the individual is from six to eight thousand dollars. The net income as here used signifies the net income as found according to the law and the regulations. From the net income is deducted the personal exemption of the individual and then the normal tax of eight percent applies only to such part of the net income as is over $4,000. Furthermore, the surtax affects only such part of the net income as is over $5,000. If the income of an individual just begins to be affected by the heavy normal tax and the surtax, the percent of the income taken by the tax is small

when compared with the entire income. As a result of this the income of the individual from other sources must be large, or the income from the source in question must be large, before the real effect of the heavy surtax is felt.

On incomes between $100,000 and $108,000 the percent of a given income that is taken by the tax increases at a greater rate than on incomes of less than $100,000. Again when the total income of the individual reaches $108,000 the percent taken by the tax does not keep up the same rate of increase as it does on smaller amounts. This is caused by the fact that the rate of the surtax increases from forty-eight percent to fifty-two percent when the net income of the individual is over $100,000 and remains at fifty-two percent until the net income is $150,000 at which point it is increased to fifty-six percent. [2]

It is worth while to point out the regularity with which the percent of the tax on a given income increases as the other income of the individual is increased. If the income tax takes twelve percent of the income from a given source when the individual has other income amounting to $10,000 it will take seventeen percent of his income from this particular source if his other income amounts to $20,000, and it will take twenty-two percent of this income if his other income amounts to $30,000. This means an average increase of one half of one percent in the tax on the income in question for every increase of $1,000 in the other income of the individual. This rate of increase begins when the other income is $6,000 and holds good until the total income is over $100,000. [3] An exception to this is found when the income from the source under consideration is small and the change in the other income is not sufficient to cause the income to be affacted by a higher rate of surtax.

2--Charts No. 2 and 3.

3--Charts No. 1 and 2.

Another point to be considered is the effect of the ownership of various shares in the partnership. One man secures ten percent and another secures ninety percent of the income of a partnership. How will the income tax affect these men? In this case there are three things to be considered: The income of the partnership; the share owned by each individual; and the income received by the individual from other sources. The two important things affecting the tax are first--What is the income received by the individual from other sources? and second--Is the income from this particular partnership large or small? [4]

As regards a particular partnership, there is an interesting relationship existing between the percent of the taxable income that is taken by the tax and the share of the partnership that is owned by the individual. The following table shows the percent of the taxable income received from a given partnership that will be taken by the income tax. In this table it is considered that in every case the individual has an income of $15,000 from other sources. The calculations made show the results for the man who is entitled to either 10%, 25%, 33 1/3%, 50%, 66 2/3%, 75%, 90%, or 98% of the taxable income of the partnership. The percentages across the top show the share of the partnership which the individual owns. The column at the left hand side gives the various amounts of taxable income of the partnership for which calculations have been made. The other columns show the percent of his share of the profits which an individual with other income of $15,000 would pay as an income tax. The last column at the right shows the average increase for each additional percent of profits claimed by the individual. The rate of increase for each additional percent owned becomes more exact as the amount of the income of the partnership increases.

4--Chart No. 43

Other Income of the Individual -- $15,000.

Income of the Company	Share Owned 10%	25%	33 %	50%	66 %	75%	90%	98%	Average increase for each additional percent owned
$ 5,000	14.	14.	14.40	14.60	14.80	14.93	15.11	15.18	.01% +)
10,000	14.	14.60	14.80	15.20	15.65	15.85	16.22	16.45	.02 ½%) approximate
15,000	14.33	14.93	15.20	15.86	16.50	16.80	17.37	17.67	.04%)
20,000	14.50	15.20	15.65	16.50	17.35	17.73	18.50	18.89	.04 ¾%--.05 ¼%
25,000	14.60	15.56	16.08	17.08	18.16	18.68	19.58	20.12	.06%--.06 ½%
35,000	14.86	16.17	16.91	18.37	19.63	20.56	21.87	22.55	.08 2/3%
50,000	15.20	17.08	18.16	20.24	22.32	23.37	25.24	26.24	.12 1/2%
75,000	15.86	18.68	20.24	23.37	26.50	28.06	30.87	32.37	.18 4/5%
100,000	16.50	20.24	22.32	26.50	30.67	32.75	36.63	38.53	.25%

In studying the table it is interesting to notice that for any given income of the partnership, the percent of income paid as a tax by individuals owning different percents of the partnership, will vary in proportion to the share owned. This variation becomes more exact as the profits of the partnership increase, provided that the total income of the individual is not over $100,000 and thus become affected by the change in the rate of the surtax mentioned heretofore. For instance the partnership has a taxable income of $100,000. The individual who secures ten percent of the profit will pay 16.50% of this income to the government as a tax. The individual who secures twenty-five percent of the profit will pay 20.24% of this income as a tax. The difference between the ten percent owned and the twenty-five percent owned or fifteen percent results in a difference of 3.74% in the tax. This makes an increase of .25% in the tax for every increase of one percent in the ownership. A study of the figures shows that this same rate of increase, .25% for each one

percent of additional ownership, holds good until the individual's total income from all sources is $100,000. Again, if the partnership has a taxable income of $25,000 the increased tax for each one percent of additional ownership is from .06% to .065%. It should also be noticed that the starting point for this table is fourteen percent, this percent being made up of a normal tax of eight percent and a surtax of six percent.

The figures in the table given show the tax when the income from other sources is $15,000. If the other income is changed the average increase for each additional one percent owned remains the same. Two exceptions should be made to this statement. First: It does not hold true when the individual has a personal exemption of $2,000 and the other income is less than $6,000. Second: It will not hold true if the total income is over $100,000.

C. The Corporation Income and Excess-Profits Taxes.

In the case of a corporation two distinct taxes are levied. First, the normal income tax of ten percent on all taxable income after the excess-profits tax and the exemption of $2,000 have been deducted.[5] Second, the excess-profits tax.[6] The excess-profits tax is based on the proportion of the taxable profit to the invested capital. Before calculating the excess-profits tax the corporation is allowed an exemption of eight percent of its invested capital plus $3,000. This exemption is known as the excess-profits credit. The excess-profits tax is found by two distinct calculations: First, the taxable income that is not over twenty percent of the invested capital, minus the excess-profits credit, is taxed at the rate of twenty percent. Second: all income over twenty percent of the invested capital, minus any of the excess-profits credit that could not be used in the first case is taxed at the rate of forty percent. The sum of the two amounts thus found constitute the excess-profits tax,as found for the calender year 1919.

As a result of the above provisions if the corporation has a small

5--Revenue Act of 1918. Section 230. (a) That -------- there should be levied, collected, and paid for each taxable year upon the net income of every corporation a tax at the following rates:
(1) For the calender year 1918, 12 per centum of the amount of the net income in excess of the credits provided in section 236; and
(2) For each calender year thereafter, 10 per centum of such excess amount.

6--Revenue Act of 1918. Section 301. (b) For the taxable year 1919 and each taxable year thereafter there shall be levied, collected, and paid upon the net income of every corporation (except corporations taxable under subdivision (c) of this section) a tax equal to the sum of the following:
20 per centum of the amount of the net income in excess of the excess-profits credit (determined under section 312) and not in excess of 20 per centum of the invested capital;
40 per centum of the amount of the net income in excess of 20 per centum of the invested capital.

invested capital the excess-profits credit will not afford much relief before the excess-profits tax of forty percent begins to take effect. To afford the necessary relief another method of computing the excess-profits tax was made. [7] It is to the effect that on a taxable income of over $3,000 and less than $20,000 a corporation should pay a tax of not more than twenty percent of this income and that on all taxable income over $20,000 it should pay/not more than forty percent of the income as a tax. This method has no reference to the invested capital and any corporation is given the privilege of using either this method or the method given in the preceeding paragraph, whichever imposes the least tax.

The calculations for the corporation tax have been made for corporations with an invested capital of $10,000; $15,000; $20,000; $25,000; $35,000; $50,000; $75,000; $100,000; $150,000, and$200,000. For each different amount of invested capital calculations have been made to find the tax the corporation would pay on an income of $5,000; $10,000; $15,000; $20,000; $25,000; $35,000; $50,000; $75,000, and $100 000. [8]

A study of chart No. 4 shows that the tax paid by the corporations with an invested capital of $25,000 and $35,000 is the same in every case given. (This will also hold true for any corporations having an invested capital that is between these two figures.) If the invested capital is $20,000, $15,000, or $10,000 the only change in the tax is when the profit is $5,000; the tax increasing as the invested capital decreases. If the invested capital of the corporation is $50,000 it will pay a different amount of tax when the profit

7--Revenue Act of 1918. Section 302. -------- the tax imposed by subdivision (b) of section 301 shall in no case be more than 20 per centum of the amount of the net income in excess of $3,000 and not in excess of $20,000, plus 40 per centum of the amount of the net income in excess of $20,000.

8--See charts No. 4 and 5 for the percent of the taxable income of the corporation that is taken by the corporation income and excess-profits taxes.

is $10,000. In all other cases studied it will pay the same tax as the corporation with an invested capital of $25,000. This similarity in the tax is caused by the method of calculating the excess-profits tax which is given in Section 302 of the Revenue Act of 1918.

Under this section the income tax cannot be more than twenty percent of the profits between $3,000 and $20,000. This means that a corporation will use Section 301 in calculating its excess-profits tax if its excess-profits credit is sufficient to reduce the tax on its profits between $3,000 and $20,000 to less than twenty percent of the profit. As the profit increases the corporation will find relief by using Section 302. As the invested capital increases the corporation will find Section 301 more to its advantage. If the profit is over $20,000 and the invested capital is less than $71,428.48 the corporation should always use the method given under Section 302. When the invested capital is from $71,428.48 to $71,428.67 it makes no difference which method is used. When the invested capital amounts to $71,428.68,or more, the corporation should always use the method given under Section 301. It should also be remembered that in every case where the method given under Section 302 is used the tax on a given income is the same regardless of the amount of the invested capital.

Attention is also called to the fact that as the invested capital of the corporation reaches $100,000, $150,000 or $200,000 on a small taxable profit the rate of the tax will be the same regardless of the amount of invested capital. This is true so long as their excess-profits credit is larger than their profit and as a result they are subject to the normal tax only.

D. The burden imposed by the income tax on the stockholder in a corporation.

While we speak of the excess-profits tax and the corporation income tax as being taxes on the income of the corporation, yet they are really borne by the individual stockholders. The profits remaining for distribution are decreased. The tax takes profits which could otherwise be distributed as dividends or if left in the corporation would enhance the value of each share of stock. Thus, each stockholder can claim that his share of the tax bears the same proportion to the total tax as the number of shares of stock he owns bears to the total number of shares of the outstanding stock. This means that when we consider the burden that the income tax places on the individual stockholder of a corporation we must consider not only the surtax which he pays on dividends but also the corporation income and excess-profits taxes. (Dividends are not subject to the normal tax.)

The following points must be considered when discussing the above problem:

(a) The invested capital of the corporation.

(b) The taxable income of the corporation.

(c) The dividends declared by the corporation from the profit remaining after the corporation income and excess-profits taxes are paid.

(d) The proportion which the shares owned by the individual bears to the entire capital stock outstanding. This will be referred to as "share owned".

(e) The amount of income received by the individual from other sources.

(f) The personal exemption of the stockholder.

Here again when considering the portion of the dividends that is taken by the tax one should find the amount of tax that the individual pays on his entire income. From this amount deduct the tax he would pay if no dividends are declared by the corporation in question. This gives the amount of tax the individual pays as a result of the dividends. The tax paid on dividends added

to his share of the tax paid by the corporation will give the total tax that he may claim as levied against his portion of the income of the corporation.

If the corporation does not pay a dividend the individual's share of the tax paid by the corporation will be the only tax that is levied against his share of the income of the corporation. Consequently in this case the rate of the tax levied against the stockholders is the same regardless of both the share owned and their income derived from other sources.

A careful study of the charts following page 24 shows the following:

First: Changes caused by the invested capital of the corporation. [9]

(a) As the invested capital increases the percent of the profits taken by the tax decreases. This is principally caused by the increase in the excess-profits credit. The following illustrates this point. For the cases studied the tax on a corporation with an invested capital of either $10,000, $15,000 or $20,000 is the same as the tax on a corporation with an invested capital of either $25,000 or $35,000 except when the profit is $5,000, the tax is increased as the invested capital is decreased. Also if the invested capital is $50,000 the only change in the results is when the profit is $10,000, the tax being smaller for a corporation of this size. [10]

(b) The greatest change is found when the taxable profit is between $5,000 and $50,000. The excess-profits credit being greater for the large corporation than for the small corporation there is not the same rapid increase in the tax when the corporation has but a small income.

9--See charts No. 8 and 9.

10--See charts No. 6, 8, 10 and 11.

Second: Changes caused by the dividends declared by the corporation from the profit remaining after the corporation income and excess-profits taxes are paid. [11]

(a) If no dividend is declared the corporation income and excess-profits taxes constitute the entire tax on this income. [12]

(b) A dividend of twenty-five percent of the profits will have the effect of increasing the individual's proportion of the tax already paid by the corporation by about two percent for every $25,000 income the individual has from other sources.

(c) A dividend of one hundred percent of the profits will have the effect of increasing the individual's proportion of the tax already paid by the corporation by about eight percent for every $25,000 income the individual has from other sources.

Third: Changes caused by difference in shares owned.

(a) If no dividend is declared the tax paid by the corporation falls with equal weight on all stockholders regardless of both the amount of stock owned and their income from other sources. [13]

(b) If the dividend is twenty-five percent of the profits remaining after the corporation income and excess-profits taxes are paid: [14]

(1) If the corporation has an invested capital of from $10,000 to $35,000 the percent of the individual's share of the income of the corporation that is taken by the tax will be practically the same whether he owns a small share or a

11--See charts No. 10,11, 12, 13.

12--See chart No. 14.

13--See chart No. 14.

14--See charts No. 10, 11,12 and 13.

large share in the corporation. For the man who owns ten percent of the stock and the man who owns ninety percent of the stock the variation is from nothing to six tenth of one percent (.6%). This variation is caused by the profit of the corporation. If the profit of the corporation is $5,000 the variation will run from nothing to .02%; if the profit is $25,000 the variation will run about .18%; if the profit is $100,000 the variation will run from .45% to .6%.

(2) If the corporation has an invested capital of $100,000 the variation is just about the same as is given above, the difference is usually less than one tenth of one percent.

(c) If the dividend is one hundred percent of the profits remaining after the corporation income and excess-profits taxes are deducted:[15]

(1) If the corporation has an invested capital of from $10,000 to $35,000 the variation in the percent of the income taken by the tax for the man who owns ten percent and the man who owns ninety percent is from one percent to seven and one half percent. The variation is caused by the profit of the corporation and not by the other income of the individual. If the profit of the corporation is $5,000 the variation is from one percent to one and three tenths percent; if the profit is $25,000 the variation is about two and three fourth percent; if the profit is $100,000 the variation is about seven and one half percent.

15--See charts No. 6 and 7.

(2) If the corporation has an invested capital of $100,000 the variation is again about the same as is given above, although it may differ at times to about one third of one percent.

The variations given in (b) and (c) above hold true regardless of whether the stockholders have an income of $15,000 or $75,000 from other sources. Two exceptions should be noted to this: First, before these variations hold true the individual's income from other sources must be subject to both the normal tax of eight percent and the surtax. Second, if the income of the individual from other sources amounts to $100,000 and the total income of the stockholders does not exceed $150,000 the tax will take the same percent of the income of the stockholder regardless as to whether they own ten percent, fifty percent or ninety-eight percent of the stock of the corporation. Third, if the other income is less than $100,000 but the total income is over $100,000 the amount of the variation between the burden placed by the taxes on the different stockholders is decreased, the amount of the decrease depending on how near the other income is to $100,000 and the share of the dividend going to each stockholder.

E. A comparison of the burden placed by the income tax on the stockholder in a corporation and the shareholder in a partnership.

If the income of an individual from other sources is $2,000 or less, it is much better for him to conduct his business in the form of a single proprietorship, or as a partnership than as a corporation. [16] The only exception to this is in the case of the individual who owns practically all the stock of the corporation, the invested capital of the corporation amounts to over $100,000, and the taxable profits are over $10,000. Even in this case it would be necessary to increase the invested capital very rapidly or an increase in the profits will give the advantage to the partnership form of organization. Again, if a man has an income of $25,000 from other sources, and his share of the profits of the business is ten percent it is best for him to operate as a partnership if the income of the business approaches $15,000. This is not true for an invested capital of $150,000 or more unless the profits amount to some $40,000. The above holds true when no dividends are paid. If dividends are paid the advantages of operating as a partnership are still more evident.

On the other hand, if the individual has an income of $50,000 from other sources he should always operate the business as a corporation if he owns more than a half interest in it. Even if he only owns ten percent of the business he should always operate as a corporation if the income of the business is not over $30,000. Again, if he has an income of $25,000 from other sources he should operate the business as a corporation if he owns an interest of ninety-eight percent and the profit of the business is not over $15,000. It is worth noticing that as the invested capital of the business increases the corporate form of organization becomes more and more advantageous. The payment of dividends by the corporation makes the corporate organization less desirable.

16--See chart No. 14.

It is difficult to give, even approximately, any general statement concerning the comparative advantages of corporate and partnership organizations. As has been seen there are several conditions affecting the results any one of which may be sufficient to throw the advantage to one organization as against the other. However, the following data give the general tendency of the effect of the more important items which must be considered. The results are stated for the various conditions which were considered.

(a) The income of the individual from other sources.

As the income of the individual from other sources increases the corporate organization becomes more advantageous provided the payment of dividends does not affect the result the other way. If he has no income from other sources he should always operate as a partnership regardless of the share owned. The same is practically always true if the other income is $2,000. When the other income is $5,000, $10,000, $15,000, or $25,000 the result will in each case be largely determined by the capital invested in the business, the income of the business, the share owned, and the dividends paid. If the other income is $35,000 the advantage on a small profit is with the corporation but as the profit increases it may be thrown either way according to the other influences. If the other income is $50,000 the corporate organization has a still greater advantage. If the other income is $75,000 or more the advantage is always with the corporation unless it is changed as the result of the payment of dividends.

(b) The effect of the invested capital.[17]

As the amount of capital invested in the business is increased it causes a reduction in the tax paid by the corporation, but will have no effect on

17--See charts No. 8 and 9.

the tax paid by a partner on the income of a partnership. An increase in the invested capital from $10,000 to $20,000 or even to $35,000 will not affect the tax on a profit of $10,000 or more. It does, however, have the effect of reducing the tax on an income of $5,000. The lowest possible tax rate on a corporation profit of $5,000 is six percent, provided the conditions studied are assumed. The invested capital of a corporation must be increased to over $71,428.67 before there will be any effect on the tax rate if the profit of the business is over $20,000. As the invested capital increases the relief is first felt on the smaller profits and the tendency is to make the increase in the tax rate more gradual. This is caused by the increase in the excess-profits credit which in turn results in a smaller excess-profits tax.

(c) The effect of the taxable profit of the business.

As the taxable profit increases the effect of the increase is to cause a larger percent of the profit to be paid as an income tax. If an individual is entitled to but a small share of the profits of a partnership an increase in the profits may cause but a small increase in the tax on his income. He must obtain a good share of the profits from the business under consideration before an increase in the profits of the partnership causes a decided increase in his income tax. If the invested capital in a corporation is small there is a rapid increase in the tax on the profits until they reach some $50,000 but after this the increase is moderate. If the invested capital of the corporation is $150,000 of $200,000 the increase in the tax on the first $15,000 or $20,000 of the profit is small but after this point is reached the increase is fairly regular on a profit up to $100,000.

(d) The effect of the share of the business owned by the individual.

(1) In a partnership an increase in the share owned causes an increase in the tax on a partner.[18] The rate of the increase is fairly regular until the total income of the partner is over $100,000.

(2) In a corporation the difference in the number of shares owned does not affect the tax on the individual if dividends are not declared. On dividends the individual is subject to the surtax when his income from other sources is $5,000 or on that part of the income from the dividends which makes a total income of over $5,000. This causes an increase in his tax. The larger the share owned the sooner will the corporate organization become the more desirable if no dividends are paid.[19]

(e) The effect of dividends declared by the corporation.

If twenty-five percent of the profits remaining after the tax is paid are declared as dividends the effect is to increase the taxes paid by the individual (result of the surtax on the dividends) and will thus make the partnership more desirable than the corporation. If all the net profits are declared as dividends the effect is to increase the tax on the individual to a point where it is better for him to operate the business as a partnership in practically every case. The only exceptions to this are when the taxable profit is $5,000 on an invested capital of $25,000 or $35,000; and when the profit is less than $20,000 on an invested capital of $100,000.[20]

To restate the above exceptions more definitely:

First: If the invested capital of a corporation is less than $35,000 and all

18--See chart No. 3 and table on page 7.

19--See charts No. 10, 11, 12, 13, and 14.

20--See charts No. 10, 11, 12, and 13.

the earnings remaining after the corporation income and excess-profits taxes are paid are declared as dividends it would always be to the interest of all of the stockholders to operate as a partnership when the taxable profit is $10,000 or more.

Second: If the invested capital is $100,000 and the other conditions remain as given above it would always be to the interest of all of the stockholders to operate as a partnership when the taxable profit is $20,000 or more. Also, if the taxable profit is $15,000, for all the stockholders who have an income from other sources of $75,000 or less it will be to their interest to operate as a partnership.

Anyone who studies the charts will be impressed by the inequalities in the levying of the tax, caused by the different methods of assessing the income of a single proprietorship or partnership on the one hand and a corporation on the other. For example, let us consider two men A and B. Each has an income of $2,000 from other sources besides the company in question and each has a personal exemption of $2,000. A secures ten percent of the profits of a partnership while B owns ten percent of the stock of a corporation, both companies have a taxable profit of $25,000. A will pay four percent of his share of the income of the partnership to the government as an income tax. If the invested capital of the corporation in which B is interested is less than $71,428.67 the income tax will take 28.64% of his share of the income of the company. Thus the tax on B is over seven times as heavy as that on A. In this case the tax on B is the same whether dividends are paid or not.

Let us vary the example by assuming that each owns ninety-eight percent of the company instead of ten percent. A will pay thirteen percent of the income of the partnership to the government while from B the government will

take 28.64% of his share of the profits even though no dividends have been declared. If all the net earnings remaining after the payment of the tax are declared as dividends the tax on B's share of the profits will be a total of 31.37% of his share of the earnings. Thus the tax on B is over two times as much as it is on A. In both of these cases the advantage is with the partnership form of organization.

Let us consider another case. X and Y each has an income from sundry sources amounting to $100,000 and each is entitled to a personal exemption of $2,000. X has a ten percent interest in a partnership and Y owns ten percent of the stock of a corporation with an invested capital of $25,000 or more. In each case the company has a taxable profit of $5,000. X will pay sixty percent of his share of the profits of the partnership to the government as an income tax. If no dividends are declared by the corporation Y can only claim that six percent of his share of the profit of the corporation is taken by the tax. In this case the tax on the owner of the partnership is ten times as heavy as the tax on the owner of the corporation.

If we vary this last case and assume that the individuals each own ninety-eight percent of the company the result will be the same if no dividends are declared by the corporation. If, however, in the last case the corporation declares as dividends all of its net earnings remaining after the taxes are paid Y will be able to claim that 54.88% of his share of the profits go to the government as taxes whether he owns ten percent or ninety-eight percent of the stock of the company. This brings their taxes within about five percent of each other but the advantage still rests with the corporate form of organization,

These illustrations based upon the same conditions, only the form of the business organization being different, show in one case that the tax borne by

the stockholder of the corporation is more than seven times that which is borne by the owners of a partnership. In another case the tax borne by the owner of a partnership is ten times that which is borne by the stockholder of a corporation. While the cases selected show a wide range of variation yet cases showing greater variations could be selected. It would also be possible to state cases where the result would be practically the same, yet it would be more difficult and would require greater care in selection. The great majority of cases have a variation of from ten to fifteen or twenty percent.

It should also be remembered that the tax on a single proprietorship is levied in the same way as a tax on a partnership. In the case of a single proprietorship the entire tax is borne by one owner, and this means that his tax will be a little larger than the tax on the individual who is entitled to ninety-eight percent of the profits of a partnership. Thus the same inequality that has been found to exist between the taxes on a partnership and a corporation will also exist between a single proprietorship and a corporation.

We may summarize the principal points into the following general facts:

First: As a result of the method of levying income taxes by the Revenue Act of 1918 the percent of the profits of a given business that is taken by the various income taxes is affected by the form of the business organization.

Second: While the burden of the tax on the partner and the stockholder may be the same it will usually be heavier in one case than in the other; in one case it will be heavier on the partner and in another case it will be heavier on the stockholder.

Third: The variation is caused by the following:
A difference in the method of levying the tax.
(a)/(The income tax is levied by one method on the members of a partnership and by another method on the stockholders of a corporation.)

(b) The amount of capital invested in the business.

(c) The taxable profit of the company.

(d) The part of the profits remaining after the corporation income and excess-profits taxes are paid that are declared as dividends by the corporation.

(e) The share owned by the individual.

(f) The amount of income received by the individual from other sources.

(g) The personal exemption of the individual.

Business Organization--Partnership

Chart showing the percent of the income received by a partner from a given partnership that is taken by the normal tax and surtax:

Provided:

(a) The partner is entitled to ten percent of the profits of the partnership.

(b) The income of the individual from other sources is the amount indicated at the right end of each line.

(c) The income of the partnership is the amount stated at the bottom of the chart.

(d) The individual is entitled to a personal exemption of $2,000.

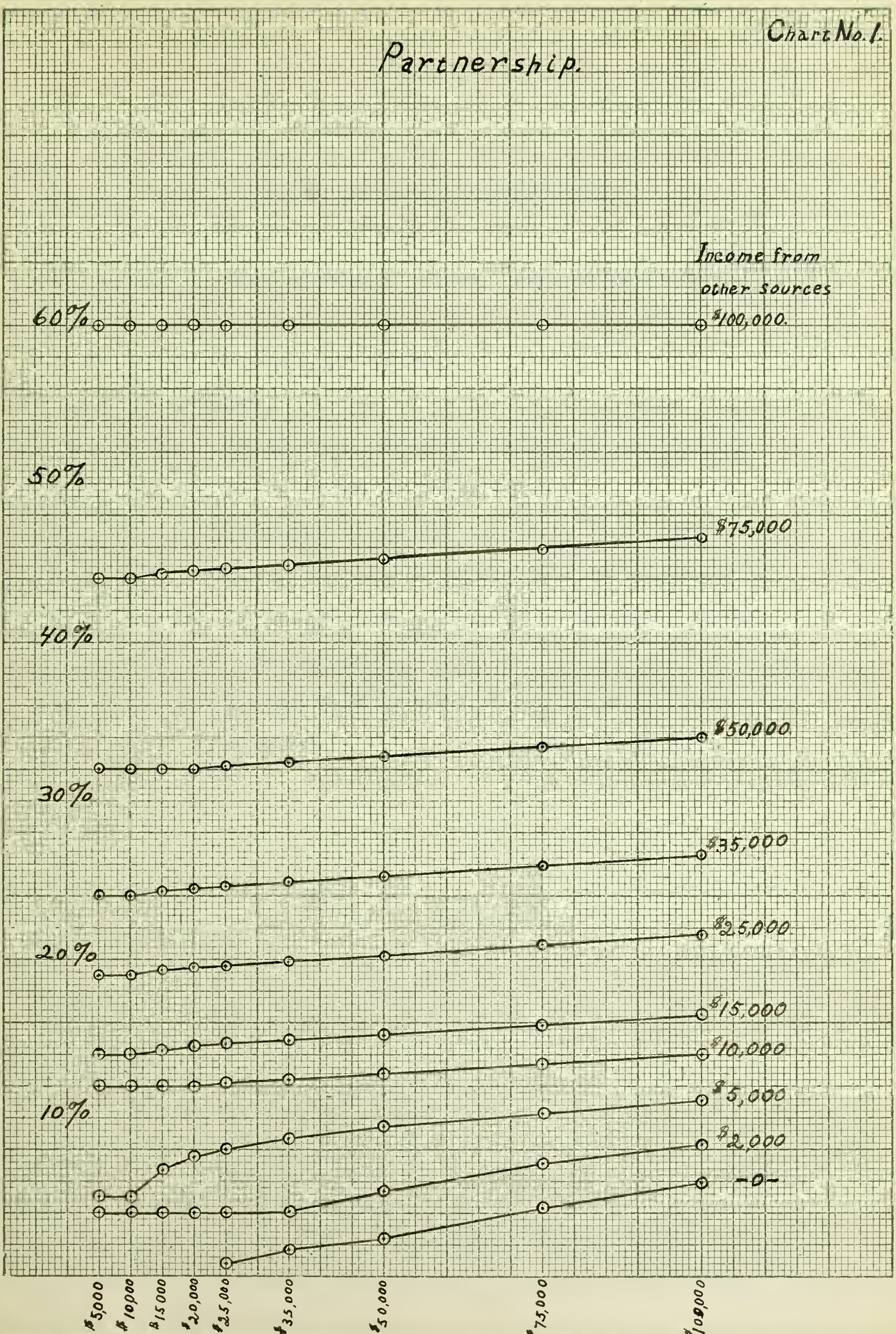


Chart No. 1.
Partnership.
Income from other sources
60%
50%
40%
30%
20%
10%
$100,000.
$75,000
$50,000
$35,000
$25,000
$15,000
$10,000
$5,000
$2,000
-0-
$5,000
$10,000
$15,000
$20,000
$25,000
$35,000
$50,000
$75,000
$100,000

Business Organization--Partnership

Chart showing the percent of the income received by a partner from a given partnership that is taken by the normal tax and surtax:

Provided:-

(a) The individual is entitled to ninety-eight percent of the profits of the partnership.

(b) The income of the individual from other sources is the amount indicated at the right end of each line.

(c) The income of the partnership is the amount stated at the bottom of the chart.

(d) The individual is entitled to a personal exemption of $2,000.

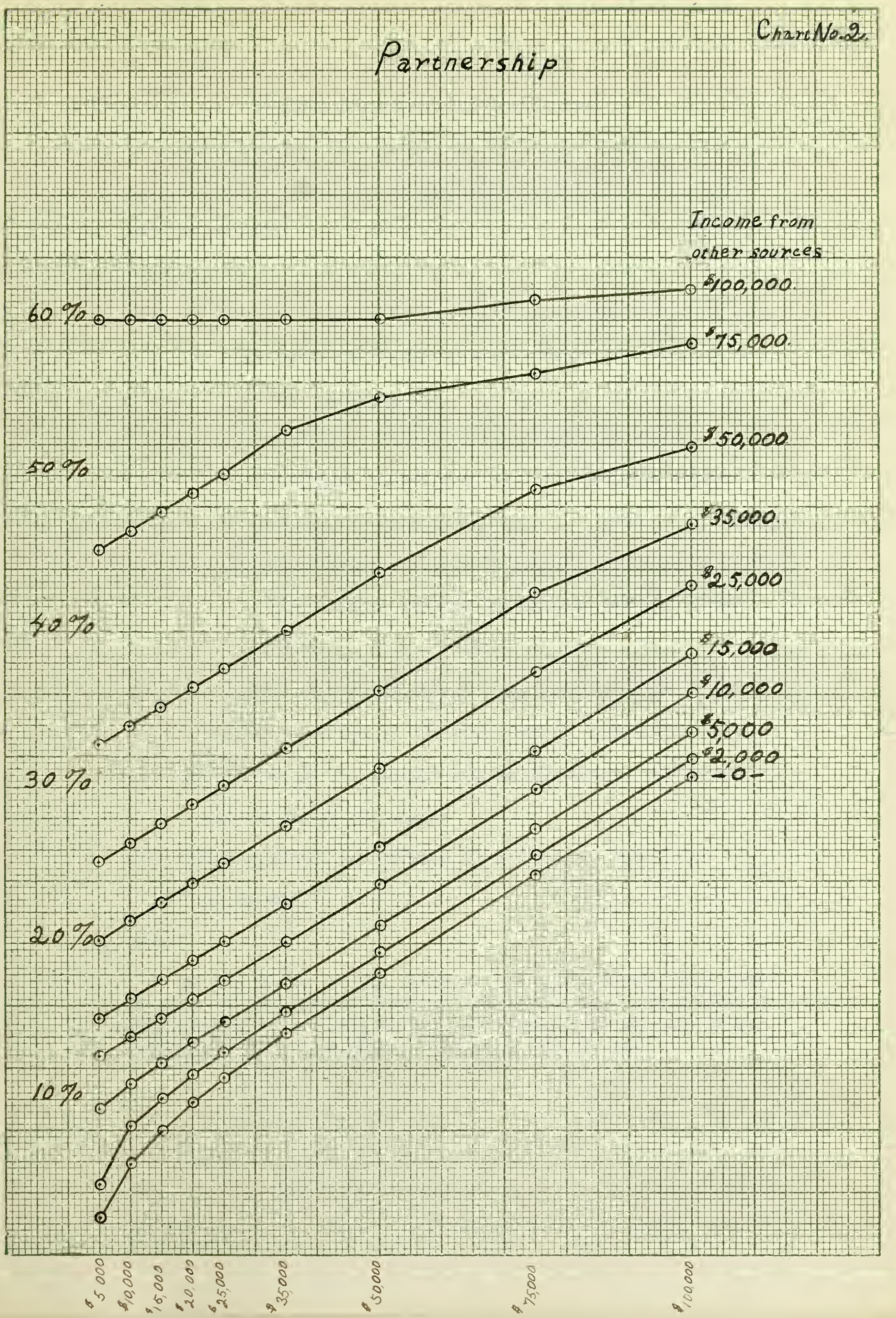


Chart No. 2.
Partnership
Income from other sources
$100,000.
$75,000.
$50,000
$35,000.
$25,000
$15,000
$10,000
$5,000
$2,000
-0-
60 %
50 %
40 %
30 %
20 %
10 %
$5,000
$10,000
$15,000
$20,000
$25,000
$35,000
$50,000
$75,000
$100,000

Business Organization--Partnership

Chart showing the percent of the income received by a partner from a given partnership that is taken by the normal tax and surtax:

Provided:

(a) 1. The red line indicates the result when the individual is entitled to ninety-eight percent of the profits of the partnership.

2. The green line indicates the result when the individual is entitled to fifty percent of the profits of the partnership.

3. The black line indicates the result when the individual is entitled to ten percent of the profits of the partnership.

(b) The income of the individual from other sources is the amount indicated at the right end of each line.

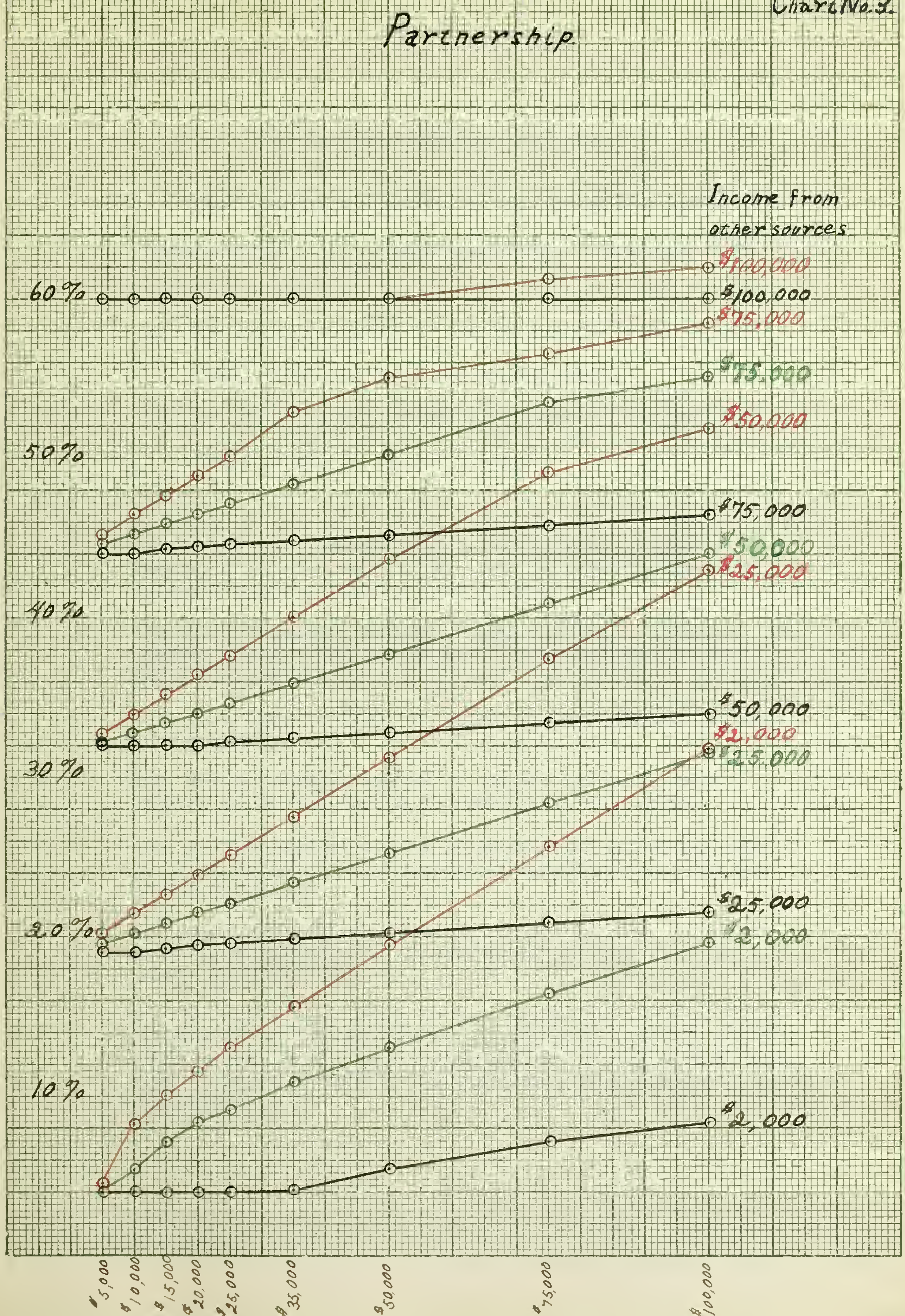
(c) The income of the partnership is the amount stated at the bottom of the chart.

(d) The individual is entitled to a personal exemption of $2,000.

Note:

If the income of the owners of the partnership from other sources is $100,000 or more the sharing of the profits does not affect the rate of tax so long as the total income of any one is not over $150,000. They all pay the same rate of tax.

Chart No. 3.



Partnership
Income from other sources
$100,000
$100,000
$75,000
$75,000
$50,000
$75,000
$50,000
$25,000
$50,000
$2,000
$25,000
$25,000
$2,000
$2,000
60 %
50 %
40 %
30 %
20 %
10 %
$5,000
$10,000
$15,000
$20,000
$25,000
$35,000
$50,000
$75,000
$100,000

Business Organization--Corporation

Chart showing the percent of the income of a corporation that is taken by the corporation income and excess profits taxes.

Conditions assumed:-

(a) The invested capital of the corporation is the amount indicated at the right end of each line.

(b) The taxable profit of the corporation is the amount stated at the bottom of the chart.

Notes:-

(1) Chart No. 5 is that portion of chart No. 4 which is marked off by the dotted line. The scale in chart No. 5 is eight times as large as that in chart No.4.

(2) On an income of $10,000 or more the tax is the same whether the invested capital is $10,000, $15,000, $20,000, $25,000 or $35,000.

(3) In no case does the tax amount to less than six percent of the profit.

(4) For an invested capital of $25,000 and an invested capital of $35,000 the tax is identical in all cases.

(5) If the invested capital is $50,000 the tax is the same as it is for an invested capital of $25,000 except when the profit is $10,000.

(6) An increase in the invested capital does not affect the rate of the tax when the taxable profit is less than the excess profits credit.

(7) If the taxable profit of the corporation is large enough to make the corporation subject to the excess profits tax of forty percent, the corporation income and excess profits taxes take forty-six percent of all additional profit earned by the corporation.

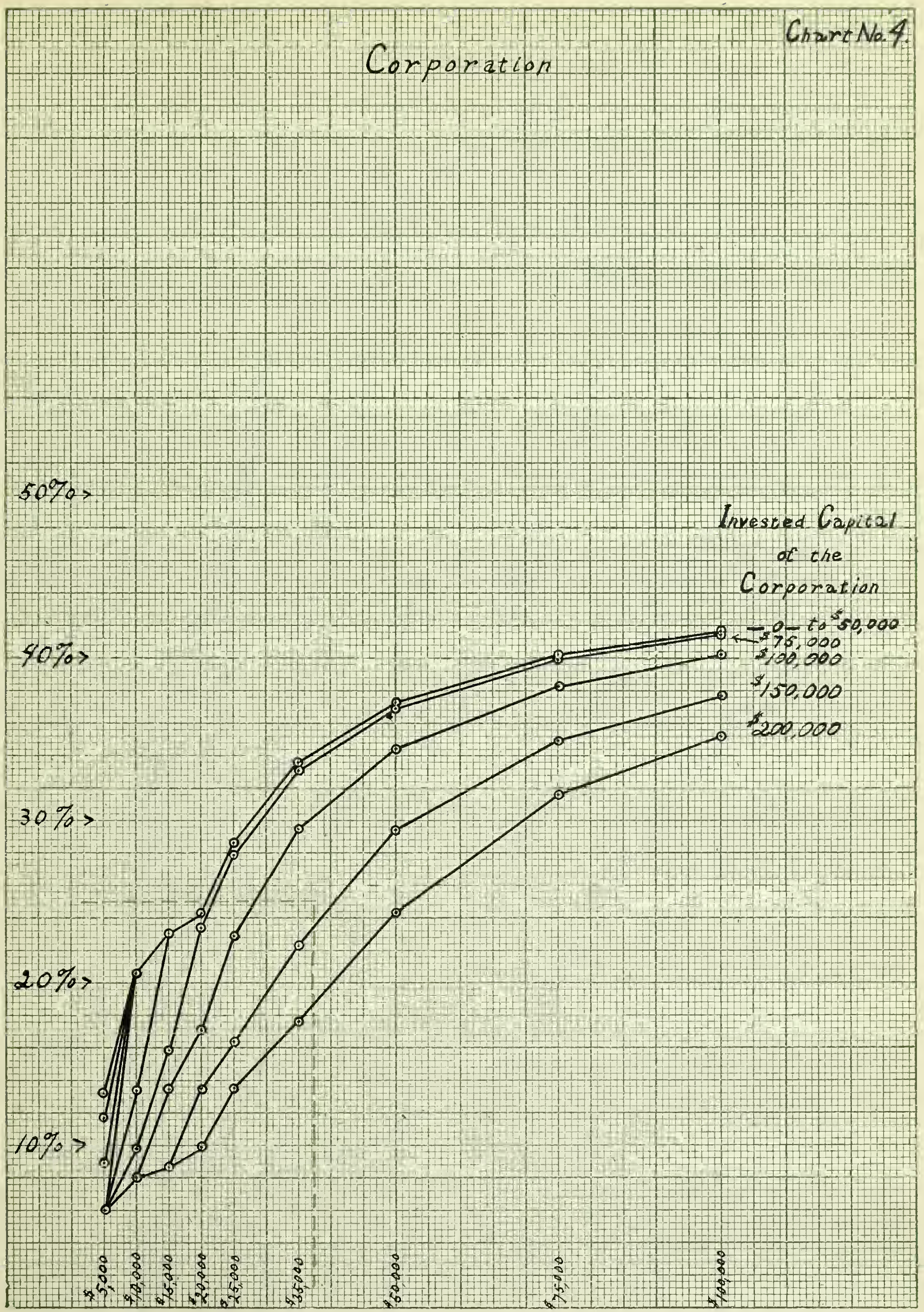


Chart No. 4
Corporation
50%
40%
30%
20%
10%
Invested Capital of the Corporation
-0- to $50,000
$75,000
$100,000
$150,000
$200,000
$5,000
$10,000
$15,000
$20,000
$25,000
$35,000
$50,000
$75,000
$100,000

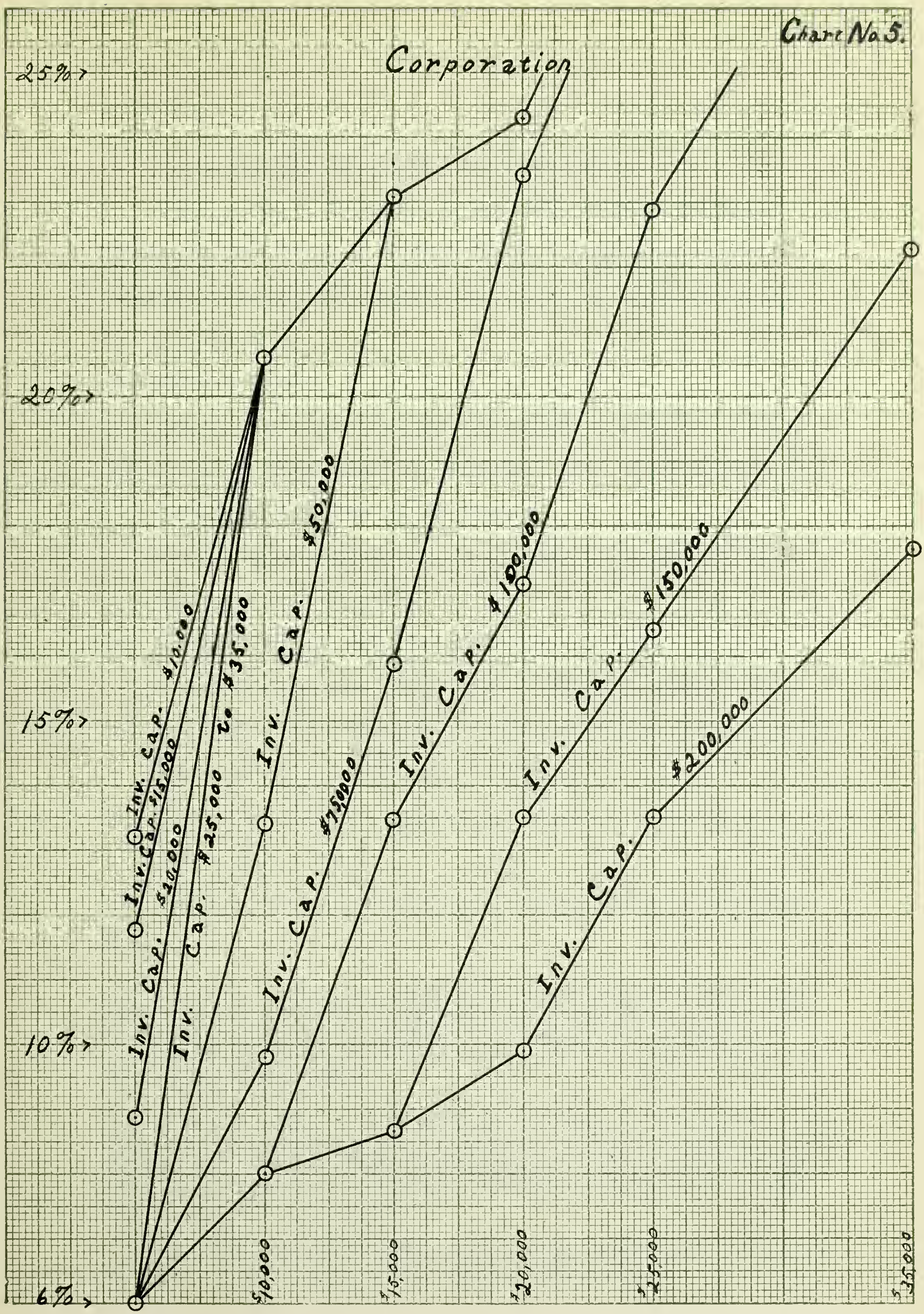


Chart No. 5.
Corporation
25%
20%
15%
10%
6%
$10,000
$15,000
$20,000
$25,000
$35,000
Inv. Cap. $10,000
Inv. Cap. $15,000
Inv. Cap. $20,000
Inv. Cap. $25,000 to $35,000
Inv. Cap. $50,000
Inv. Cap. $75,000
Inv. Cap. $100,000
Inv. Cap. $150,000
Inv. Cap. $200,000

Business Organization--Corporation

Chart giving a comparison of the burden laid on the large stockholder and the small stockholder of a corporation by the corporation income and excess-profits taxes and the surtax paid by the individual.

Conditions assumed:-

(a) The invested capital of the corporation is $25,000 or $35,000.

(b) The black lines indicates the result when the stockholder owns ninety-eight percent of the stock.

The red lines indicate the result when the stockholder owns ten percent of the stock.

(c) All the earnings remaining after the corporation income and excess-profits taxes are paid are distributed as dividends.

(d) The income of the stockholder from other sources is the amount indicated at the right end of each line.

(e) The income of the partnership is the amount stated at the bottom of the chart.

(f) The individual is entitled to a personal exemption of $2,000.

Notes:-

(1) The line showing the lowest rate of tax indicates the percent paid by the corporation as an income and excess profits tax. This line practically agrees with the line showing the tax paid by a stockholder who owns ten percent of the stock and whose income from other sources is $2,000.

(2) When the income of the individual is $100,000 the percent taken when the stockholder owns ten percent of the stock is practically the same as when he owns ninety-eight percent. This is caused by the fact that the surtax of fifty-two percent is levied on all incomes between $100,000 and $150,000.

(3) The lines show a definite variation and are largely influenced by the corporation income and excess profits taxes.

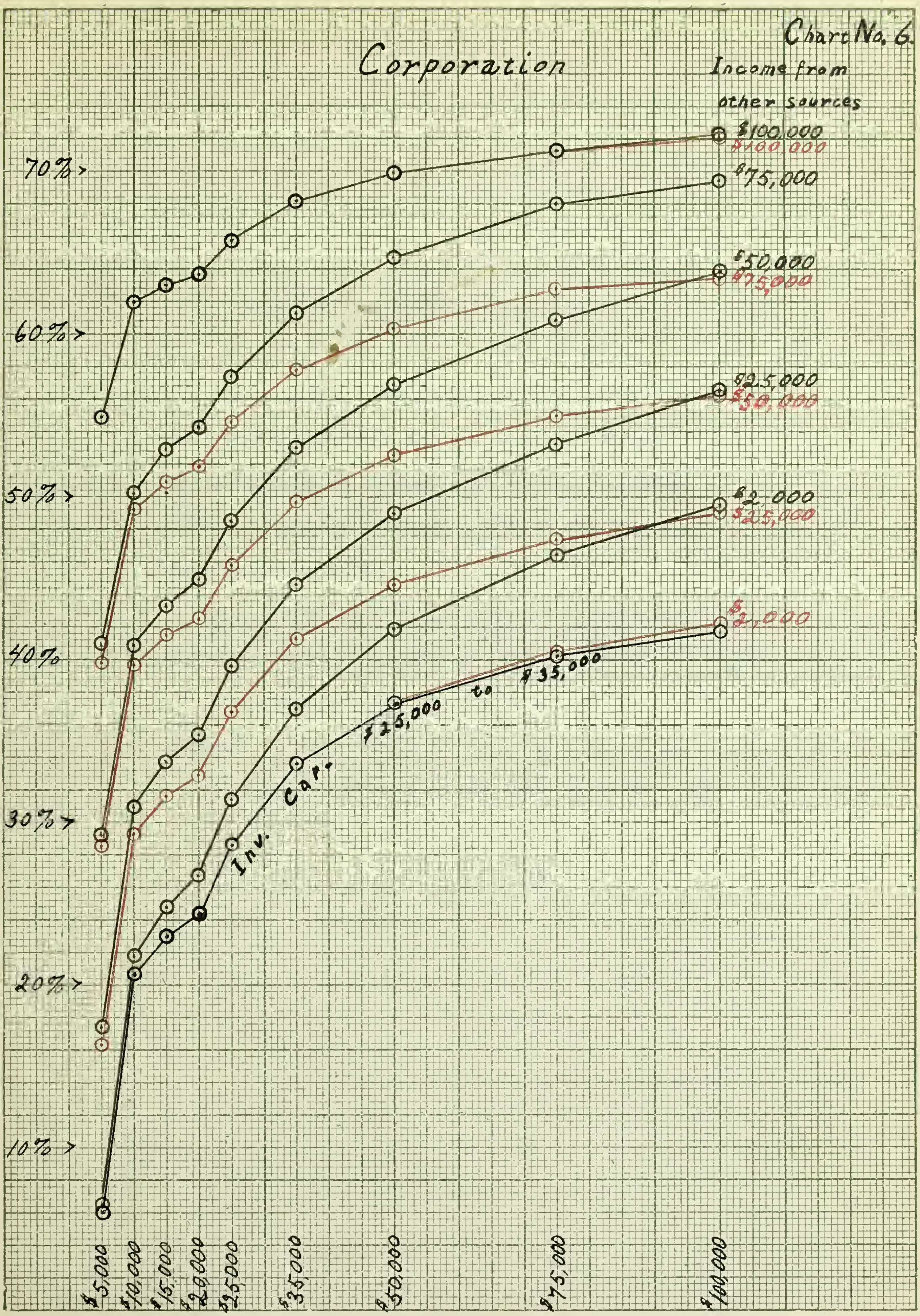


Chart No. 6.
Corporation
Income from other sources
$100,000
$100,000
$75,000
$50,000
$75,000
$25,000
$50,000
$2,000
$25,000
$2,000
Inv. Cap.
$25,000 to $35,000
70%
60%
50%
40%
30%
20%
10%
$5,000
$10,000
$15,000
$20,000
$25,000
$35,000
$50,000
$75,000
$100,000

Business Organization--Corporation

Chart giving a comparison of the burden laid on the large stockholder and the small stockholder of a corporation by the corporation income and excess-profits taxes and the surtax paid by the individual.

Conditions assumed:-

(a) The invested capital of the corporation is $100,000.

(b) All the other conditions are the same as are given for chart No. 6.

Notes:-

Notes are the same as are given for chart No. 6.

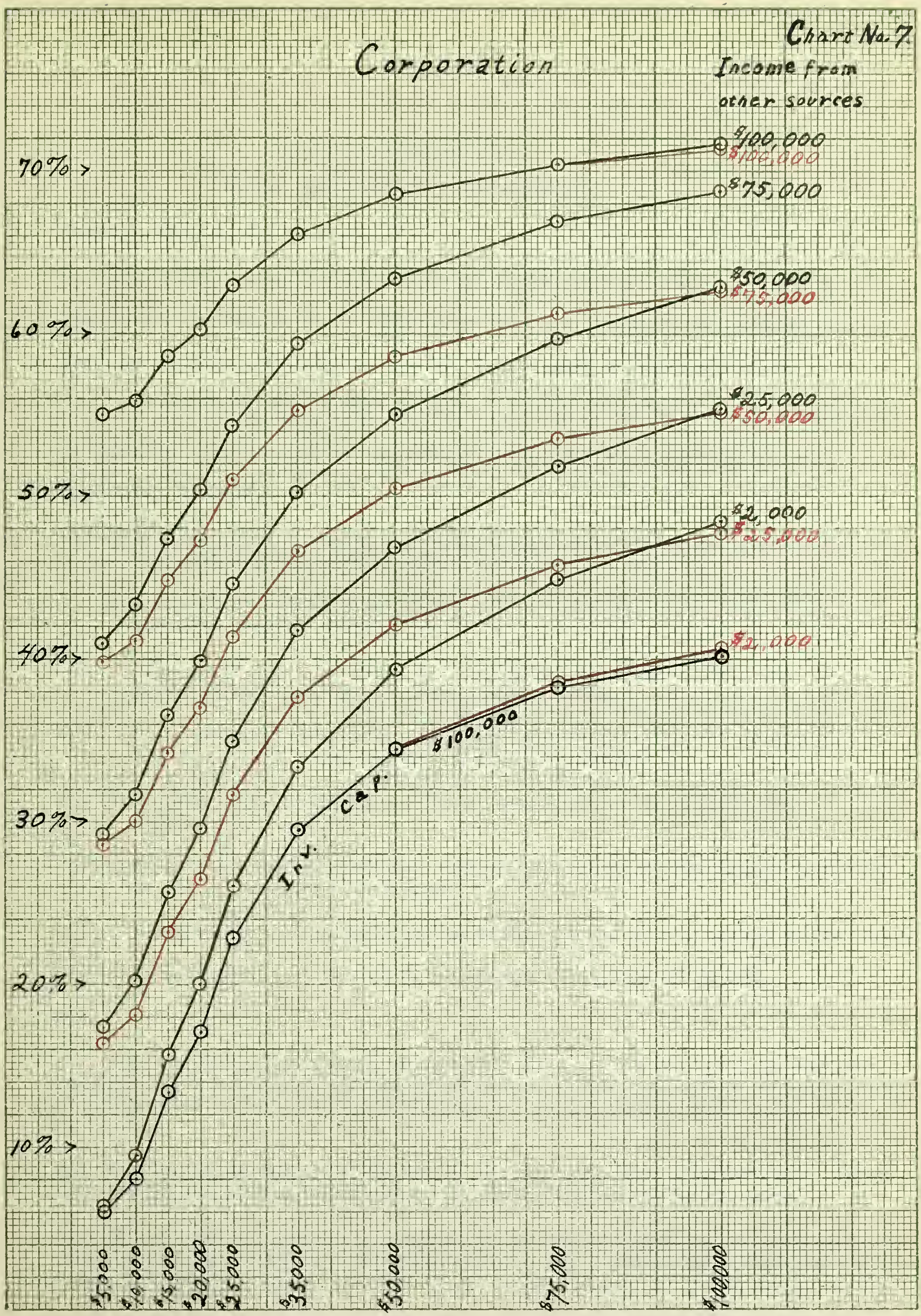


Chart No. 7
Corporation
Income from other sources
$100,000
$100,000
$75,000
$50,000
$75,000
$25,000
$50,000
$2,000
$25,000
$2,000
$100,000
Inv. Cap.
70%
60%
50%
40%
30%
20%
10%
$5,000
$10,000
$15,000
$20,000
$25,000
$35000
$50,000
$75,000
$100,000

Business Organization

Either Corporation or Partnership.

Results shown by the chart:-

I. The effect of the invested capital of the corporation on the percent of the profits belonging to the individual that are taken by the corporation income and excess-profits taxes and the surtax paid by the individual.

II. The burden imposed by the income tax on the stockholder of a corporation as compared with the burden imposed on the member of a partnership.

Conditions assumed:-

(a) The black lines indicate the result for a corporate organization with an invested capital of $25, 000 or $35,000.

The red lines indicate the result for a corporate organization with an invested capital of $100,000.

(b) In all cases the individual owns ten percent of the stock or is entitled to ten percent of the profits of the business.

(c) All the earnings remaining after the corporation pays its income and excess-profits taxes are declared as dividends.

(d) The green lines indicate the tax if the business is organized as a partnership.

(e) The income of the stockholder from other sources is the amount indicated at the right end of each line.

(f) The income of the business is the amount stated at the bottom of the chart.

(g) The individual is entitled to a personal exemption of $2,000.

Notes:-

(1) The two lines starting at six percent show the percent paid by the corporation as an income and excess profits tax. If no dividend is declared this is the percent of the profits belonging to the stockholder that is taken by the tax.

(2) The tax on an income of $5,000 is the same for both corporations. Therefore the burden on the stockholders of both corporations is the same.

(3) The difference between the burden on the stockholders in the two corporations is caused entirely by the difference in the corporation income and excess-profits taxes and this in turn is caused by the amount of the invested capital.

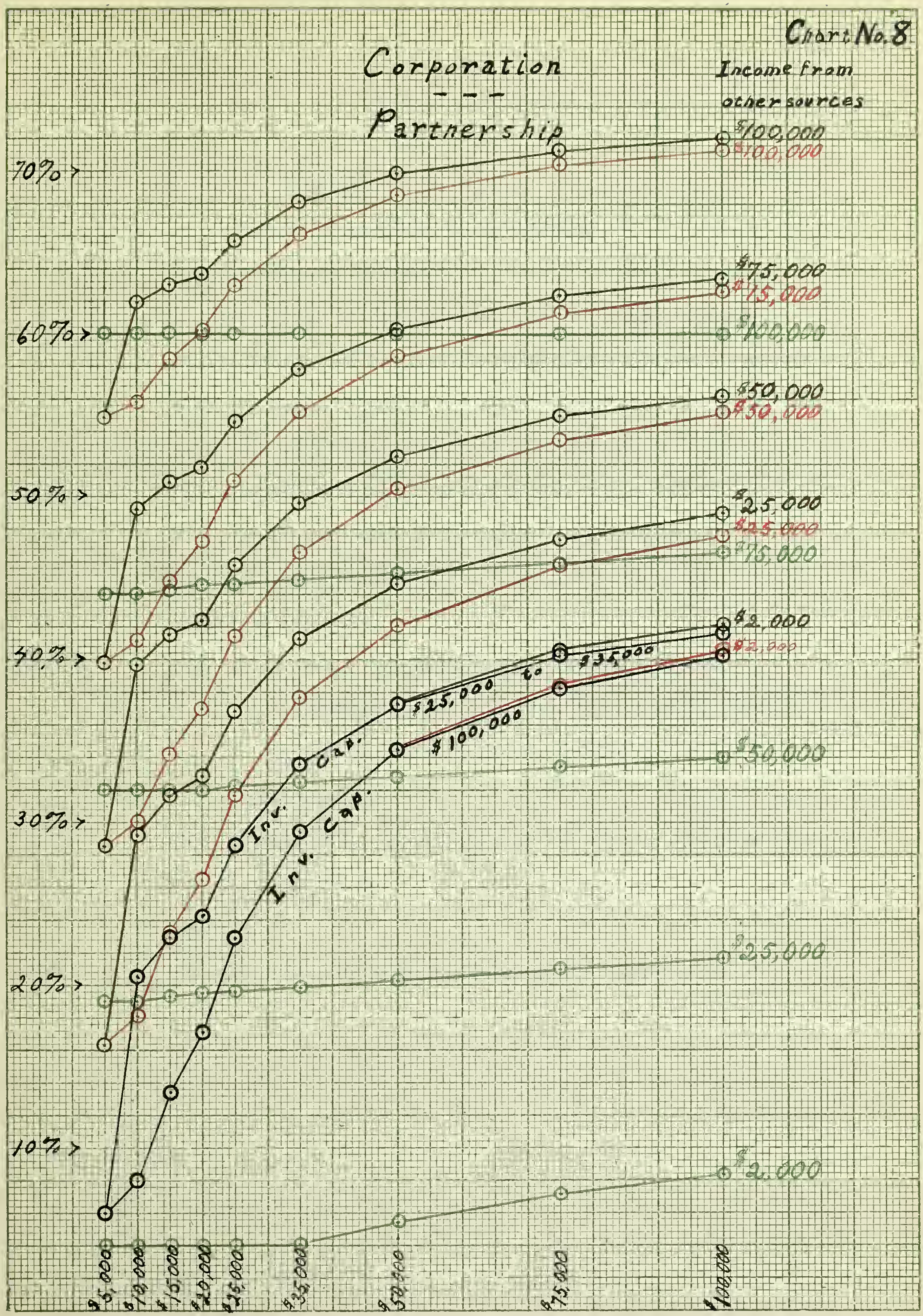


Chart No. 8
Corporation
Partnership
Income from other sources
$100,000
$100,000
$75,000
$75,000
$100,000
$50,000
$50,000
$25,000
$25,000
$75,000
$2,000
$2,000
$25,000 to $35,000
$100,000
Inv. Cap.
Inv. Cap.
$50,000
$25,000
$2,000
70% >
60% >
50% >
40% >
30% >
20% >
10% >
$5,000
$10,000
$15,000
$20,000
$25,000
$35,000
$50,000
$75,000
$100,000

Business Organization

Either Corporation or Partnership

Results shown by the chart:

I. The effect of the invested capital of the corporation on the percent of the profits belonging to the individual that are taken by the corporation income and excess-profits taxes and the surtax paid by the individual.

II. The burden imposed by the income tax on the stockholder of a corporation as compared with the burden imposed on the member of a partnership.

Conditions assumed:

(a) In all cases the individual owns ninety-eight percent of the stock of the corporation or is entitled to ninety-eight percent of the profits of the partnership.

(b) All the other conditions are the same as are given for chart No. 8.

Notes:

The notes are the same as are given for chart No. 8.

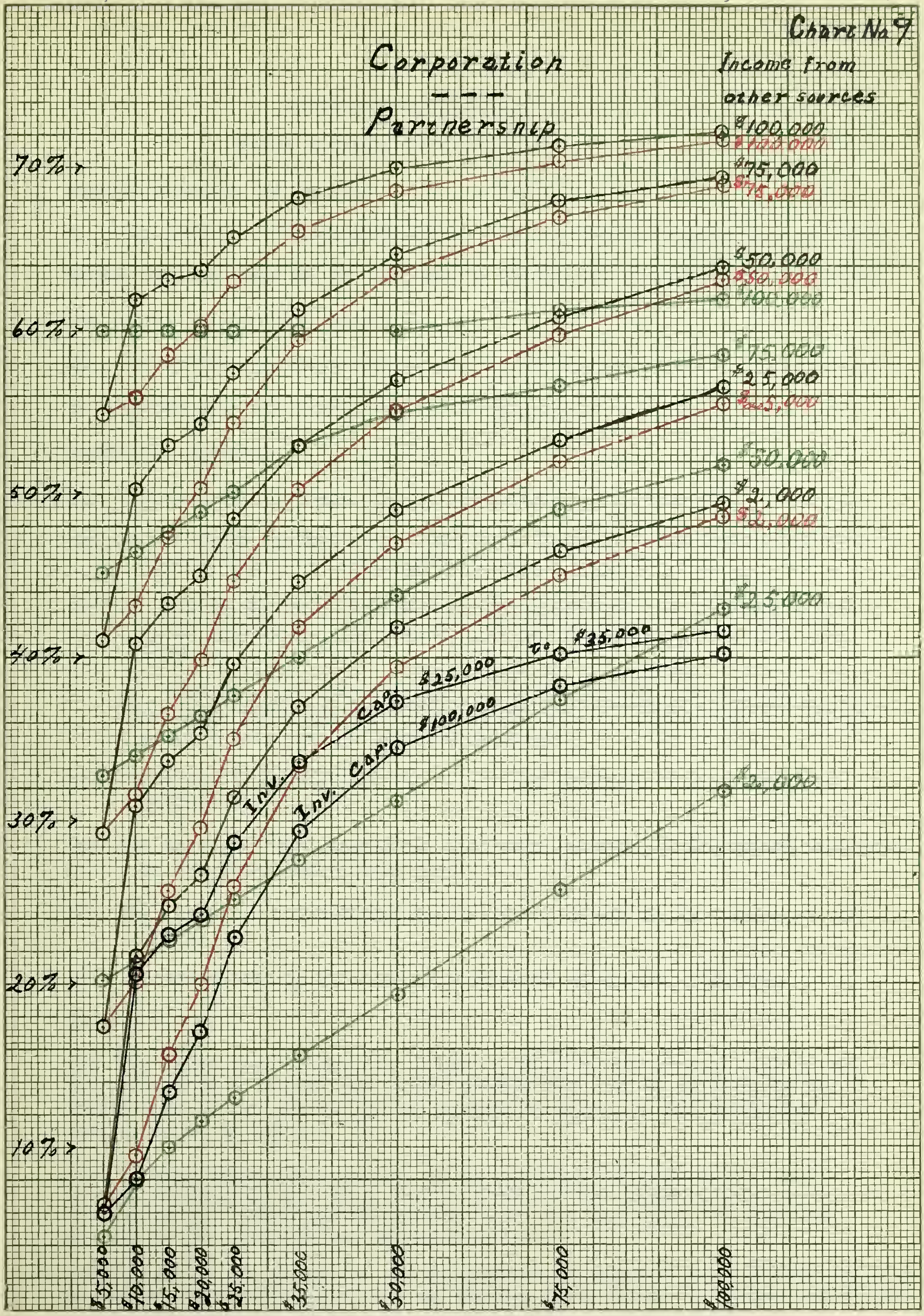


Chart No. 9
Corporation
- - -
Partnership
Income from other sources
$100,000
$100,000
$75,000
$75,000
$50,000
$50,000
$100,000
$75,000
$25,000
$25,000
$50,000
$2,000
$2,000
$25,000
$35,000
$2,000
70%
60%
50%
40%
30%
20%
10%
Inv. Cap. $25,000 to $35,000
Inv. Cap. $100,000
$5,000
$10,000
$15,000
$20,000
$25,000
$35,000
$50,000
$75,000
$100,000

Business Organization

Either Corporation or Partnership.

Results shown by the chart:-

I. The effect of dividends on the percent of profits belonging to a stockholder that is taken by the corporation income and excess-profits taxes and the surtax paid by the individual.

II. The burden imposed by the income tax on the stockholder of a corporation as compared with the burden imposed on the member of a partnership.

Conditions assumed:-

(a) The invested capital of the corporation is either $25,000 or $35,000.

(b) In all cases the individual owns ten percent of the stock or is entitled to ten percent of the profits of the business.

(c) 1. The black lines indicate the result when all the earnings remaining after the corporation pays its income and excess profits taxes are declared as dividends.

2. The red lines indicate the result when twenty-five percent of the earnings remaining after the corporation pays its income and excess profits taxes are declared as dividends.

(d) The green lines indicate the tax if the business is organized as a partnership.

(e) The income of the stockholder from other sources is the amount indicated at the right end of each line.

(f) The income of the business is the amount stated at the bottom of the chart.

(g) The individual is entitled to a personal exemption of $2,000.

Notes:-

(1) The black line showing the lowest rate of tax gives the percent paid by the corporation as an income and excess profits tax. If no dividend is declared this is the percent of the profits belonging to the stockholder that is taken by the tax.

(2) If only twenty-five percent of the earnings are paid as dividends and the stockholder has other income of $2,000 the stockholder is not subject to the surtax and the lowest black line also gives the rate of the tax on his share of the corporation income.

(3) If all of the income of the corporation is declared as dividends the rate of the tax on the income of the man who has other income of $2,000 varies but little from the rate paid by the corporation.

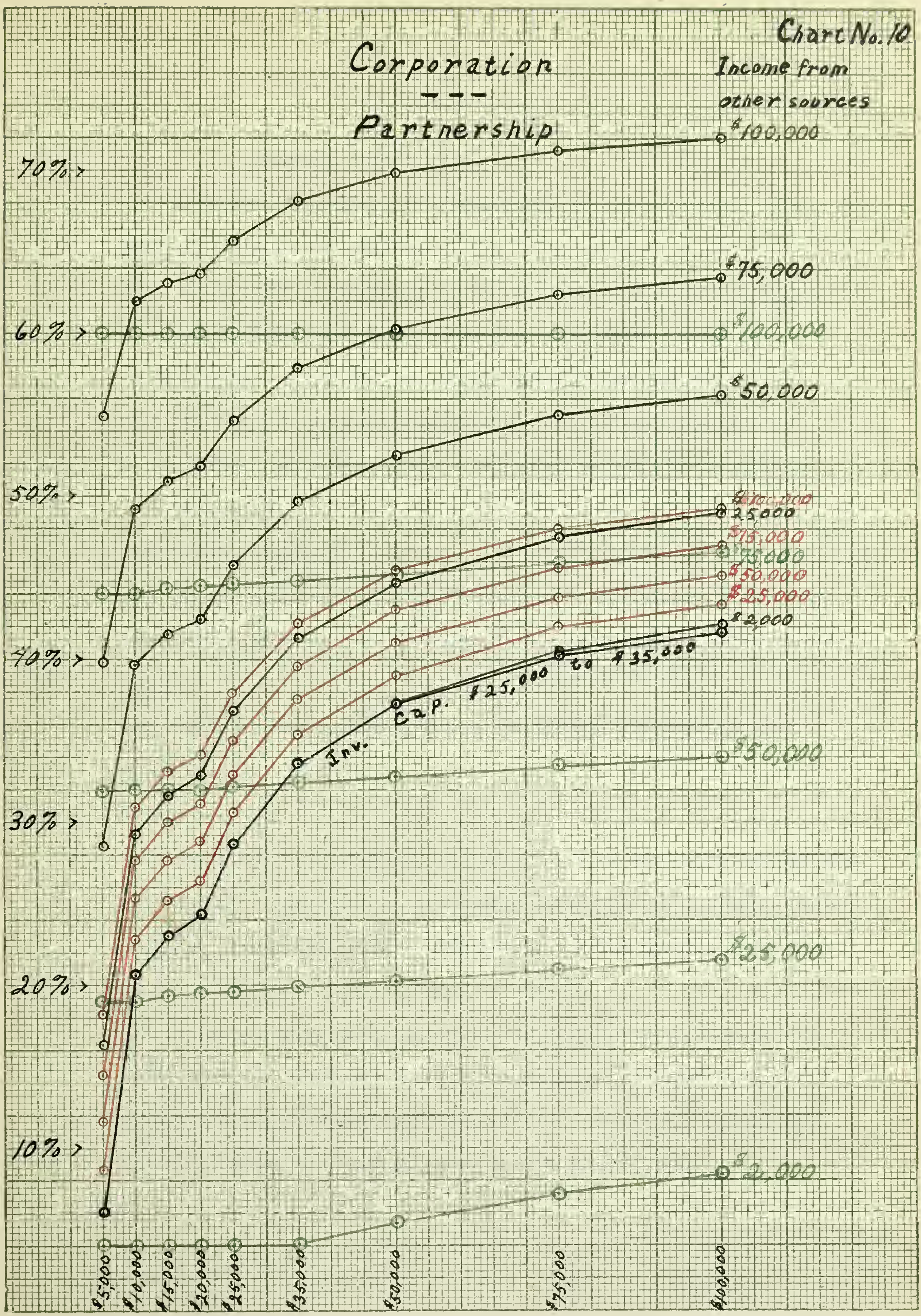


Chart No. 10
Corporation
Partnership
Income from other sources
$100,000
$75,000
$100,000
$50,000
$100,000
25,000
$15,000
$75,000
$50,000
$25,000
$2,000
Cap. $25,000 to $35,000
Inv.
$50,000
$25,000
$2,000
70%
60%
50%
40%
30%
20%
10%
$5,000
$10,000
$15,000
$20,000
$25,000
$35,000
$50,000
$75,000
$100,000

Business Organization

Either Corporation or Partnership

Results shown by the chart:-

I. The effect of dividends on the percent of profits belonging to a stockholder that is taken by the corporation income and excess-profits taxes and the surtax paid by the individual.

II. The burden imposed by the income tax on the stockholder of a corporation as compared with the burden imposed on the member of a partnership.

Conditions assumed:-

(a) In all cases the individual owns ninety-eight percent of the stock or is entitled to ninety-eight percent of the profits of the business.

(b) All the other conditions are the same as those given for chart No. 10.

Notes:-

(1) The black line showing the lowest rate of tax gives the percent paid by the corporation as an income and excess profits tax. If no dividend is declared this is the percent of the profits belonging to the stockholder that is taken by the tax.

(2) If only twenty-five percent of the income of the corporation is declared as dividends and the stockholder has other income of $2,000 the line showing the percent taken very nearly agrees with the line showing the percent paid by the corporation.

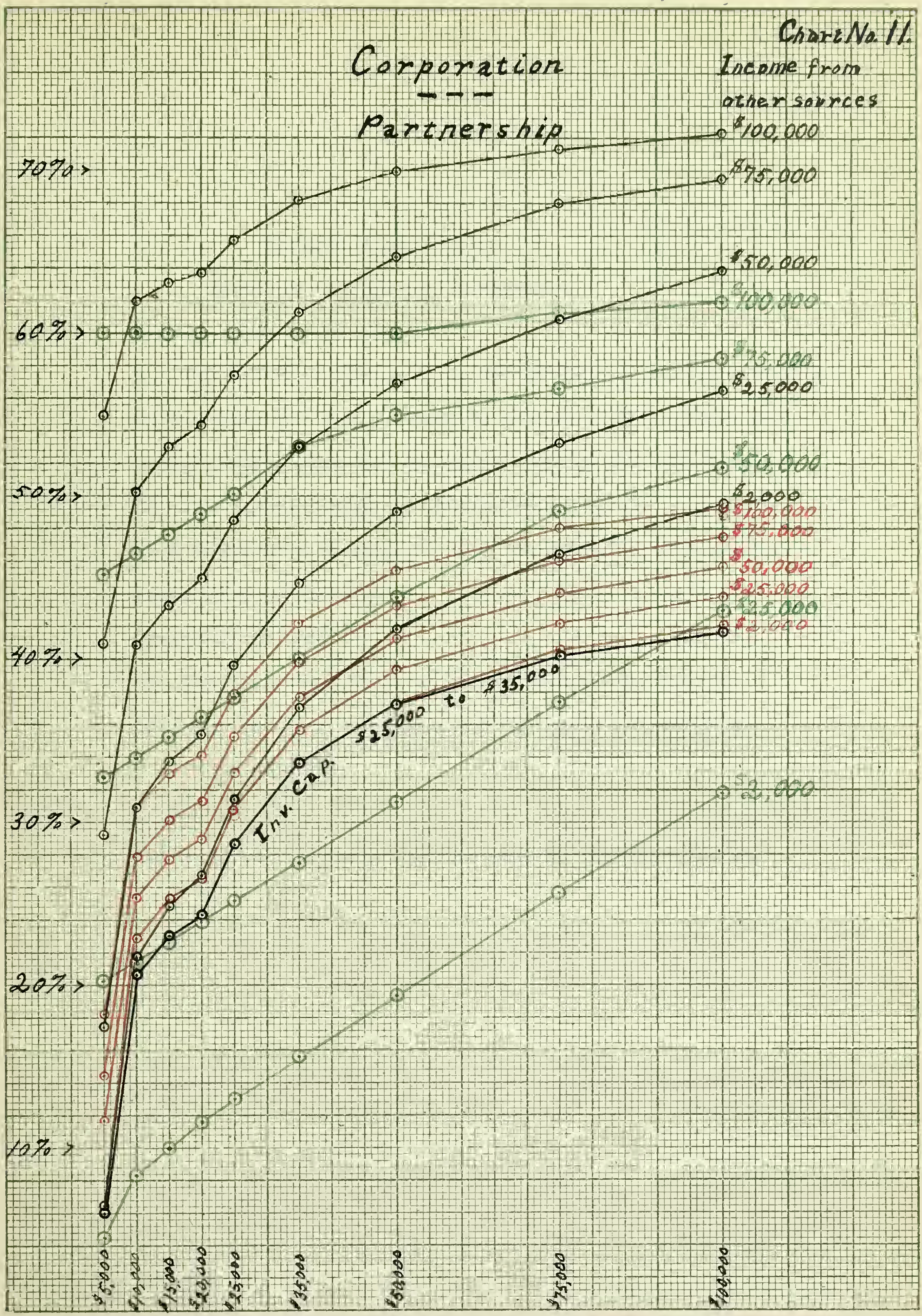


Chart No. 11.
Corporation
Partnership
Income from other sources
$100,000
$75,000
$50,000
$100,000
$75,000
$25,000
$50,000
$2,000
$100,000
$75,000
$50,000
$25,000
$25,000
$2,000
$2,000
70% >
60% >
50% >
40% >
30% >
20% >
10% >
Inv. Cap.
$25,000 to $35,000
$5,000
$10,000
$15,000
$20,000
$25,000
$35,000
$50,000
$75,000
$100,000

Business Organization

Either Corporation or Partnership.

Results shown by the chart:-

I. The effect of dividends on the percent of profits belonging to a stockholder that is taken by the corporation income and excess-profits taxes and the surtax paid by the individual.

II. The burden imposed by the income tax on the stockholder of a corporation as compared with the burden imposed on the member of a partnership.

Conditions assumed:-

(a) The invested capital of the corporation is $100,000.

(b) All the other conditions are the same as those given chart No. 10.

Notes:--

The notes for this chart are the same as for chart No. 10.

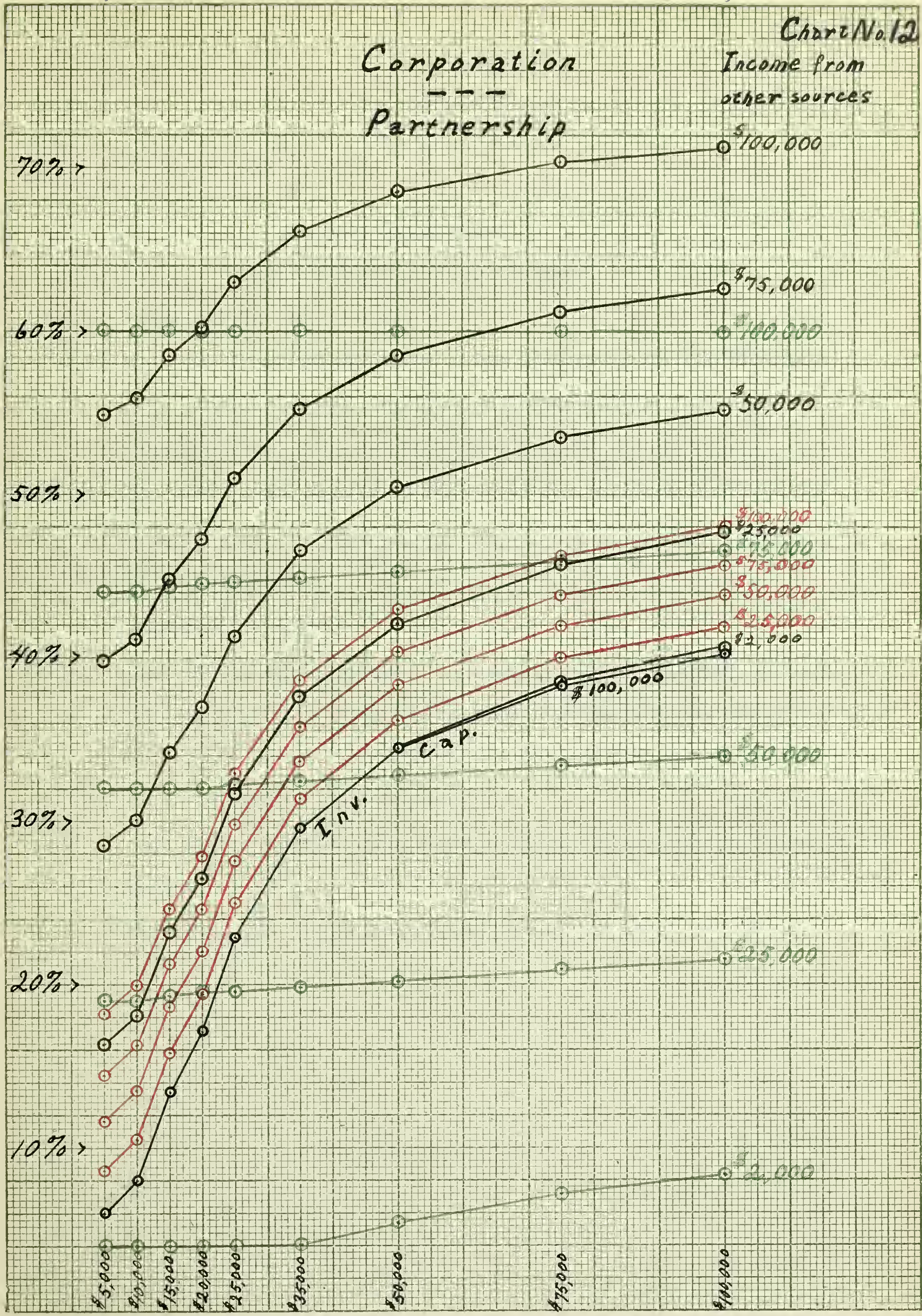


Chart No. 12
Corporation
— — —
Partnership
Income from other sources
$100,000
$75,000
$100,000
$50,000
$100,000
$25,000
$75,000
$75,000
$50,000
$25,000
$2,000
$100,000
Cap.
Inv.
$50,000
$25,000
$2,000
70% >
60% >
50% >
40% >
30% >
20% >
10% >
$5,000
$10,000
$15,000
$20,000
$25,000
$35,000
$50,000
$75,000
$100,000

Business Organization

Either Corporation or Partnership

Results shown by the chart:-

I. The effect of dividends on the percent of profits belonging to a stockholder that is taken by the corporation income and excess-profits taxes and the surtax paid by the individual.

II. The burden imposed by the income tax on the stockholder of a corporation as compared with the burden imposed on the member of a partnership.

Conditions assumed:-

(a) The invested capital of the corporation is $100,000

(b) In all cases the individual owns ninety-eight percent of the stock or is entitled to ninety-eight percent of the profits of the business.

(c) All other conditions are the same as those given for chart No. 10.

Notes--

The notes for this chart are the same as for Chart No. 11.

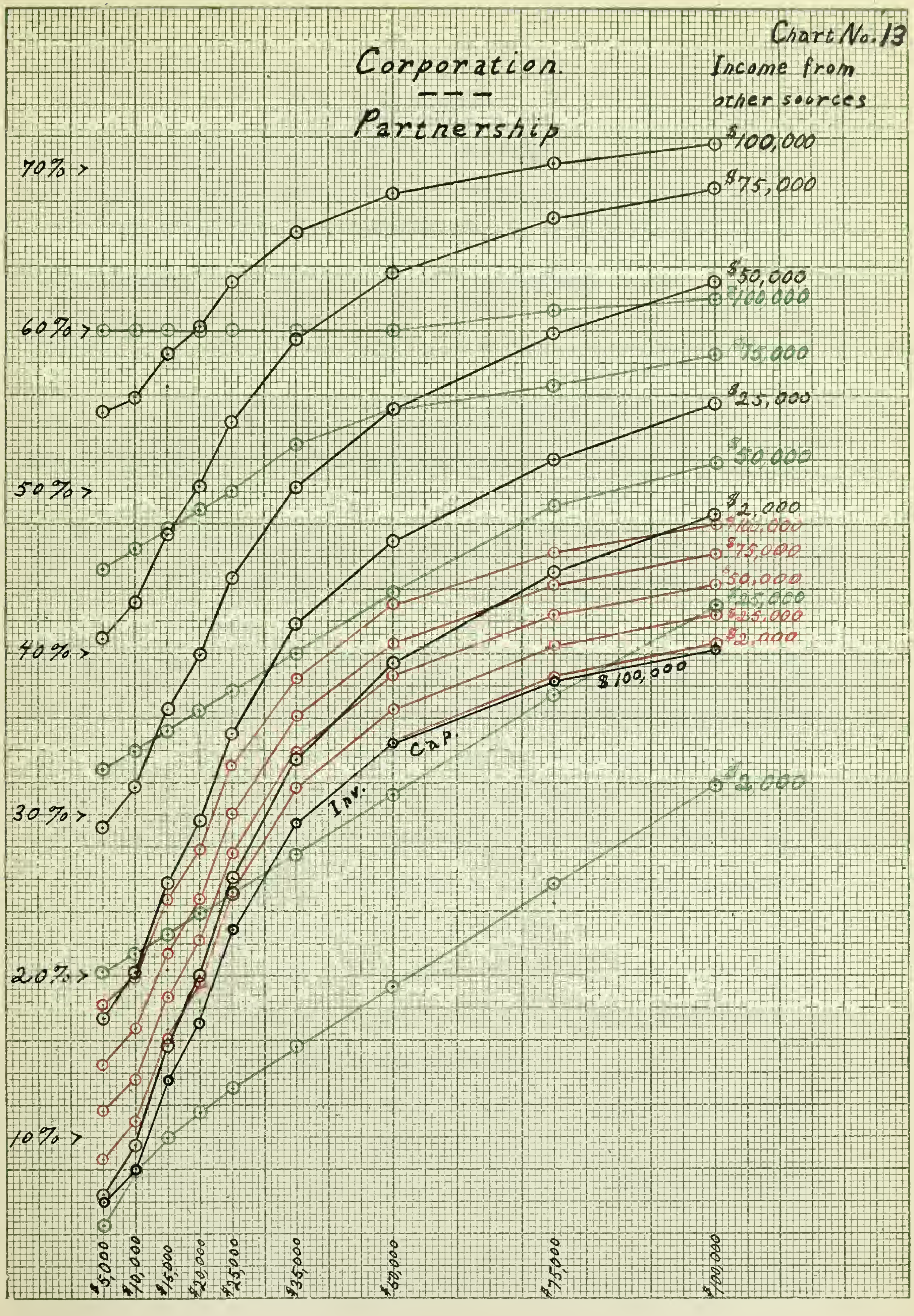


Chart No. 13
Corporation.
Partnership
Income from other sources
$100,000
$75,000
$50,000
$100,000
$75,000
$25,000
$50,000
$2,000
$100,000
$75,000
$50,000
$25,000
$25,000
$2,000
$100,000
Cap.
Inv.
$2,000
70%
60%
50%
40%
30%
20%
10%
$5,000
$10,000
$15,000
$20,000
$25,000
$35,000
$50,000
$75,000
$100,000

Business Organization

Either Corporation or Partnership

Chart showing a comparison of the burden imposed by the income tax on the stockholder of a corporation as compared with the burden imposed on the member of a partnership.

Conditions assumed:-

(a) The black lines indicate the percent of the income of corporations of various sizes that is taken by the corporation income and excess-profits taxes.

(b) The black lines also show the percent of the income of the stockholder that is taken by the tax when no dividends are declared by the corporation. The results are the same regardless of the number of shares owned.

(c) Share of partnership owned:

(1) The solid red lines indicate the percent taken by thetax when the partner is entitled to ninety-eight percent of the profits of the partnership.

(2) The broken red lines indicate the percent taken by the tax when the partner is entitled to fifty percent of the profits of the partnership.

(3) The green lines indicate the percent taken by the tax when the partner is entitled to ten percent of the profits of the partnership.

(d) The income of the individual from other sources is the amount indicated at the right end of each line.

(e) The income of the business is the amount stated at the bottom of the chart.

(f) The individual is entitled to a personal exemption of $2,000.

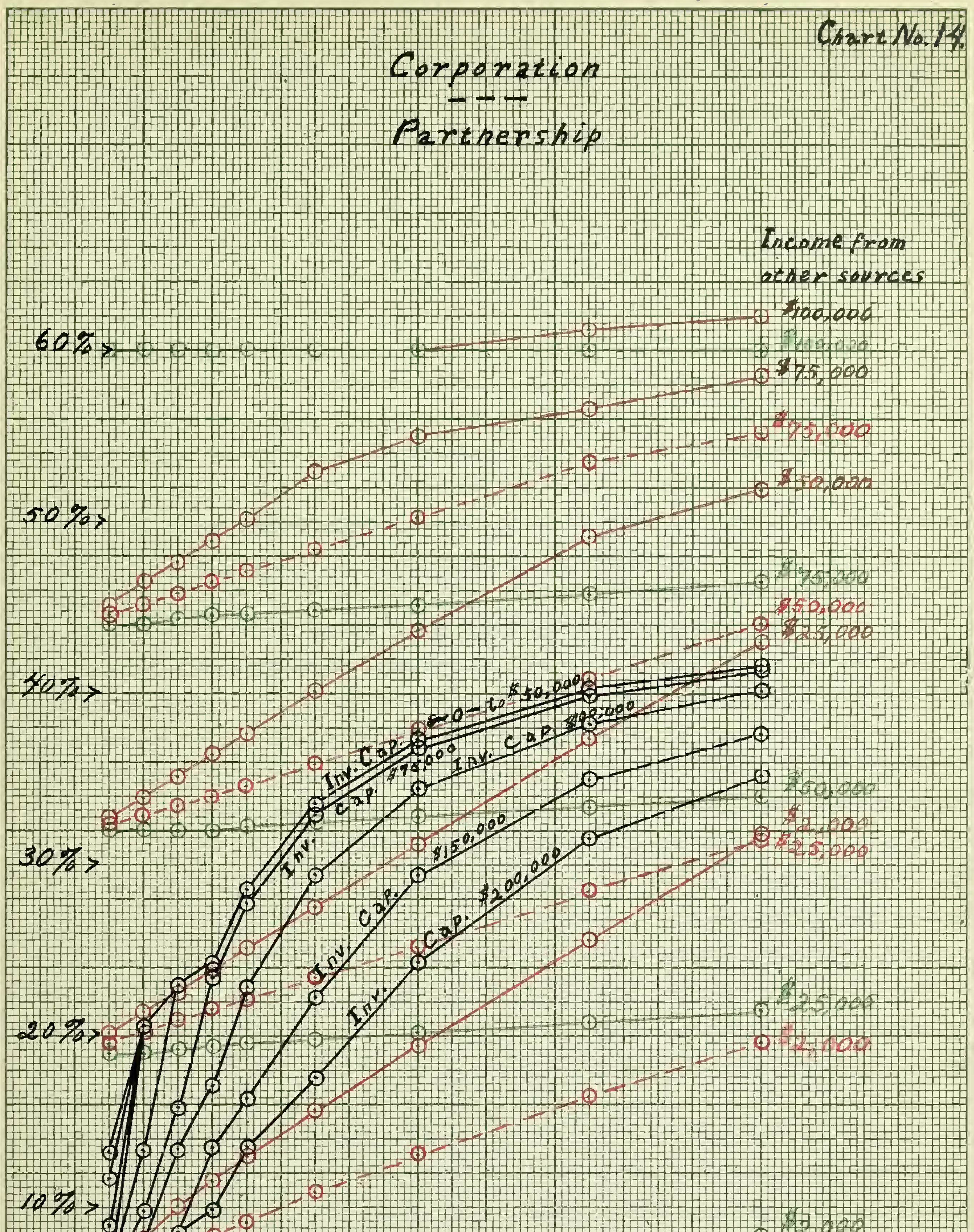


Chart No. 14
Corporation
Partnership
Income from other sources
$100,000
$100,000
$75,000
$75,000
$50,000
$75,000
$50,000
$25,000
$50,000
$2,000
$25,000
$25,000
$2,000
$2,000
60%
50%
40%
30%
20%
10%
0 to $50,000
Inv. Cap. $75,000
Inv. Cap. $100,000
Inv. Cap. $150,000
Inv. Cap. $200,000
$5,000
$10,000
$15,000
$20,000
$25,000
$35,000
$50,000
$75,000
$100,000

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